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18 December 2024

Dear Jade and Andrew,

Response to the statutory consultation on the Post Construction Review of the Viking Link interconnector to Denmark

National Grid Interconnector Holdings Limited (NGIH) welcomes the opportunity to respond to Ofgem's minded-to position on the Post Construction Review (PCR) of the Viking Link interconnector project and the statutory consultation on consequential changes to the special licence conditions of National Grid Viking Link Limited (NGVLL).

NGIH is the legal entity within the National Grid group responsible for interconnector development and the management of existing operational interconnector businesses. NGIH comprises a 100% investment in NG Viking Link Limited, National Grid Interconnectors Limited (NGIFA), National Grid IFA2 Limited (NGIFA2) and National Grid North Sea Link Limited (NGNSL); together with a 50% interest in BritNed Development Limited and Nemo Link Limited. NGIH represents NGVLL, NGIFA2 and NGNSL, which are also regulated under the cap and floor (C&F) regime.

As the regulated route for electricity interconnector development in Great Britain (GB), the C&F regime represents a significant and positive regulatory innovation. The regime has successfully incentivised the development of GB electricity interconnection capacity and delivered benefits to consumers through enhanced security of supply, access to lower electricity prices and has already facilitated reduced transmission charges through early above cap revenue payments made by Nemo Link and NGIFA2. In addition, interconnectors provide a vital tool to decarbonise the energy system, by allowing renewable energy to move from where it is produced to where it is most needed. In this context, the successful implementation of the C&F regime is critical to allowing those benefits to GB consumers to be realised.

<u>PCR Cost Assessment</u>

We are pleased that in its minded-to PCR allowances, Ofgem has assessed that most of the costs submitted by NGVLL for developing, constructing and operating Viking Link are economic and efficient. Ofgem's proposed capex cost disallowances total £12.2m (in 2019/20 prices), representing ~0.7% of the total GB share of project costs that we submitted in the PCR for NGVLL. Included within this £12.2m is a £3.9m disallowance for Delay in Start-Up (DSU) insurance, which is a category of costs that Ofgem has an established policy position (to disallow) in the Final Project Assessment (FPA) and PCR under the cap and floor regime which is a policy that we fundamentally disagree with.

Of the minded-to disallowances which have all been made to capex, we do not agree with Ofgem's assessment that all the proposed reductions to NGVLL's submitted costs are justified on efficiency considerations and have responded to each disallowance in turn in Appendix 1. Due to the level of detail provided a redacted version is attached as Appendix 1

Particularly we would like to point out that the supply market in which Viking Link carried out its construction in was a very different environment to the market when the project was developed and contracts entered. Disallowing the costs associated with the guaranteed vessel availability and extended warranty fails to recognise the importance of the risk mitigations that were introduced to ensure timely delivery of critical infrastructure. By disallowing costs such as these there is a risk of setting a poor precedent for future projects which are also going to be constructing in such challenging supply markets.

Proposed licence modifications and updates to NGVL's financial parameters

We agree with all the proposed licence modifications and parameters with the exception of the levels of corporation tax and capital allowance applied in Ofgem's minded-to PCR position. The tax rates used result in cap and floor levels that are not commensurate to the magnitude of costs faced by NGVLL for the foreseeable future.

Please see our detailed response to your questions in Appendix 2.

If you would like to discuss any of the contents of this response, please contact Sallie Griffiths (Sallie.Griffiths@nationalgrid.com).

Kind regards,

Sally Lewis
Head of UK Policy and Regulation

Appendix 1 – NGIH's position on Ofgem's minded-to disallowances.

Question 1: Do you agree with our proposed cost allowances?

Disallowances to be given high priority for reconsideration

- **Guaranteed vessel availability (£2.0m):** Ofgem are minded-to disallow the cost of having vessels on standby during the cable late-stage testing as they believe the level of cost incurred failed to meet the threshold for what would be considered economic and efficient. NGIH disagree with this conclusion and believe the analysis suggests it is economic and efficient.

  Vessel availability is very much a critical path component, impacting any repair operation, in the case of a fault on the submarine cable. As market conditions, which has worsened since project award, and the number of projects currently under execution heavily influence the possibility to book vessels at short notice, there was a real risk any fault identified would result in a significant delay to the operational live date of Viking Link.

  Extension to warranty period of a section of cable at UK landfall (£4.0m): Ofgem are minded to disallow the cost of an extension from five to ten years to the warranty of a section of the cable as they feel it exposes consumers to costs associated with potential damage caused by the contractor. NGIH strongly disagree with this sentiment and believe that the approach taken to the concern was made in the consumers interests. By taking the action of extending the warranty, it minimises the length of any future outage caused by a fault to this section of the cable, which would both affect consumer prices of electricity and protect future revenue which could then be returned to consumers via the cap and floor mechanism.

  NGVL faced a situation whereby they suspected a section of cable may have been compromised by a potential overbend of the cable during laying. There was insufficient evidence to demonstrate that damage to the internal structure of the landfall cable was sustained during installation and therefore, contractually, liability could not be imposed on the contractor. However, from the evidence available, there is a known increased risk that damage to the cable could materialise in the future and under these circumstances, the responsibility for any future repair only sits with the contractor, within the defined defects period which is five years. It should be noted that any future fault is likely to occur in a severely constrained supply chain market.

- **Acceleration works (£0.6m):** We disagree that this should be categorised as an inefficient cost. NGVL requested that Prysmian bring forward an activity (cable termination works), and in doing so Prysmian incurred additional cost in redeploying tasks and personnel. The reason for making this request was to avoid an overlap in timing with an activity (installation of the HV equipment) being carried out by the converter station contractor Siemens. The impact of making this request mitigated impacts to the overall schedule and reduced the challenges and safety issues associated with two contractors working in the same area. Therefore, NGIH consider it to be an allowable project expense.

- **Intermediate high voltage (HV) testing (£0.2m)** NGIH believe there is some misunderstanding regarding costs which were incurred as part of a settlement agreement with Prysmian for €6.5m in 2022. The majority of the costs within the settlement agreement were deemed economic and efficient (€4.5m) within the RIGs review process, with the remaining €2m classified as minded to be disallowed. The minded-to disallowances included €1.5m (£0.6m NG share) for acceleration of works (see above) and €0.5m (£0.2m NG share) for HV testing. No rationale has been provided for disallowing the costs associated with HV testing, which was a distinct activity from the acceleration of works. We do not consider the HV testing to be acceleration and Ofgem have subsequently approved related expenditure for other HV tests completed.

Viking Link identified that a potential failure of the final end-to-end test, which was due to take place in 2023, presented the largest risk impacting a timely energisation of the asset. As a result, the Viking Link team assessed whether integrating additional tests into the programme would prove to be beneficial to the overall project risk profile. The potential impact of identifying a cable fault in a failure of the end-to-end test would be substantial, with a likelihood of delayed project completion due to the associated time to rectify the issue. By contrast, the costs of undertaking intermediate tests, at carefully selected points in the programme, offered an efficient and economic means of mitigating this risk of delayed completion resulting from previously unidentified cable faults. As such, the conclusion was that the additional intermediate tests would provide overall value to the project through mitigating one of the principal project risks. Ofgem agreed with the prudent approach taken, to help guarantee the timely delivery of the project. Therefore, NGIH believe that this cost should also be allowed.

Other comments on the minded to disallowances

- **<u>Delay in Start-Up (DSU) insurance (£3.9m):</u>** NGIH continue to consider that DSU insurance could provide significant benefits to consumers, if treated within the scope of the cap and floor regime. However, we recognise that Ofgem has taken a consistent position that neither the cost of this insurance, nor any insurance proceeds from it, are in the scope of the cap and floor regime and Ofgem has indicated that this is a firm policy position.

- **<u>UK Food subsidy scheme (£0.1m):</u>** Ofgem have disallowed this cost as they believe it sits outside the scope of costs that can be included in the cap and floor which equates to only costs essential to the development, construction, and operation of the interconnector. NGIH believe that expenditure related to a cared-for workforce and the resulting increased productivity makes this a justifiable cost given the importance of well-being in the construction industry.

- **<u>Launch event (£0.4m):</u>** We recognise that Ofgem is inclined to disallow expenses related to the launch event; however, NGIH believe that events like these indirectly serve consumer interests and should be considered an allowable project expense. The primary goal of the event is to strengthen public and political support for European interconnection by emphasising the benefits of the asset to both nations and positioning the UK as a leader in this field. This approach enhances the prospects for ongoing cooperation in operating the asset and supports future interconnection efforts to benefit both countries as we work toward achieving Net Zero.

- **<u>Remaining risk budget (£0.6m):</u>**

- **<u>Additional UXO Survey Option (£0.5m):</u>** This contract option was originally included in the NGVL FPA submission but was not utilised during the Project. NGVL acknowledge that inclusion within the PCR submission was in error they neglected to remove the cost from the final PCR submission and thank Ofgem for highlighting and removing the cost.

Appendix 2 - NGIH's position on financial parameters

Q1. Do you agree with our proposed modifications to NGVL's special licence conditions?

We agree with the modifications proposed by Ofgem to the special licence conditions. These modifications reflect changes to the Cap and Floor Financial Model (1 and 2) and Handbook, Floor start date and Full commissioning date as per Appendix 3.

Q2. Do you agree with our proposed changes to NGVL's financial parameters, specifically its corporation tax rate?

We do not agree with the corporation tax rate or the capital allowance rate which are financial parameters used in setting NGVL's cap and floor levels.

Viking Link took Final Investment Decision (FID) in September 2018, when the published corporation tax rate was 19%, which was then used to calculate the preliminary cap and floor levels at FPA. Since April 2023, the corporation tax rate has increased to 25% and this was the prevailing rate on the day that the asset entered commercial operations. This deviation represents a significant shortfall in the tax liability assumed in the calculation of NGVL's allowed annual returns versus the known tax burden that will be faced in operations.

Similarly in October 2018, the UK government announced a reduction of rate of special writing down allowance (capital allowance rate) of 6% from the financial year 2019/2020[1] and this level is still in place. This is compared to the rate of 8% which applied at the time of FID just one month previously.

It is critical that the rates in the final cap and floor calculations align to the actual rates that the licensee will be subject to, as opposed to a rate set even before the construction of the asset. Developers should be able to earn returns that are commensurate with the levels of costs they are exposed to under the regulatory framework.

With the current political atmosphere and economic outlook including advice from IMF[2], not to reduce taxation to maintain fiscal stability, the United Kingdom is expected to see a prolonged rate of high(er) taxation. As such, we maintain that a tax allowance of 25% and 6%, is a fair representation and aligns to present day.

Therein, NGIH does not agree with the principle that the corporation tax rate should be locked at FID, that being a rate that is applicable at a point in time before construction and years ahead of the asset entering operations. We reiterate our position as detailed in our communication to Ofgem dated 24 of May 2023[3].

We also note that the anomaly has now been recognised for Window 3 interconnectors[4] and also aligns with the RIIO regime[5], where actual tax rates will be taken into account to achieve cost neutrality. This significantly reduces the risk of tax exposure to the developer (which is outside their control).

[1] https://www.gov.uk/government/publications/reduction-of-rate-of-special-writing-down-allowance-for-capital-allowances/capital-allowances-reduction-of-rate-of-special-writing-down-allowance

[2] https://www.imf.org/en/News/Articles/2024/01/31/tr013024-transcript-of-january-2024-weo-update-press-briefing

[3] May 2023, NGV - Application of corporation tax rate for setting final cap and floor levels at PCR

[4] September 2021, Ofgem - Application Guidance for the Third Cap and Floor Window for Electricity Interconnectors, P. 20, 4.8

[5] July 2024, Ofgem - RIIO-3 Sector Specific Methodology Decision – Finance Annex, P.161

Incorporating a mechanism into the existing cap and floor model, to periodically vary corporation tax and capital allowance rates to reflect actual rates, represents an ideal approach to the treatment of these parameters. Such a mechanism would constitute a fair and symmetrical treatment of tax for both licensees and consumers and would avoid arbitrary gains or losses arising from timings of fixing a project's tax allowances. However, if the corporation tax rate is fixed for the regime duration, we do not agree with the principle that it should be locked at FID that being a rate that is applicable at a point in time before construction, and years ahead of the asset entering operations.

We propose that, if a fixed corporation tax rate assumption approach is to be used, it should either be based on:

(1) The prevailing view of HM Treasury corporation tax rate(s) for the duration of the regime period, at the time that Ofgem publishes the PCR consultation (i.e., the point in time when the cap and floor levels are being finalised); or
(2) The prevailing corporation tax rate on the date at which the interconnector entered operations.

Either of the above options would provide a more representative snapshot of the corporation tax rate applicable to the operational interconnector (than the rate that was prevailing at FID, years before entering operations).

Q3. Do you agree with reverting to the use of IUMAMRZC for the calculation of risk-free rate for the IDC?

We agree with the use of IUMAMRZC for the calculation of risk-free rate in the IDC. This aligns and is consistent with the IDC calculation used with other Window 1 interconnectors. The use of IUMAMRZC i.e. 10-year average of monthly yields on real 10-year UK Gilts at the date of FID and its use is consistent also with Regime Handbook[6] for W1 projects.

We support the reflected change in the IDC albeit with minor impact and subsequent changes to (special) license conditions to reflect the change in the Cap and Floor Financial Models and Handbook.

[6] September 2021, Ofgem – Regime Handbook, P.84